

2002**Investment Interest Expense Deduction**

Attach to Form 540, Long Form 540NR, or Form 541.

3526

Name(s) as shown on return

Social security number or FEIN

1	Investment interest expense paid or accrued in 2002. See instructions	1	
2	Disallowed investment interest expense from 2001 form FTB 3526, line 7. If zero or less, enter -0-	2	
3	Total investment interest expense. Add line 1 and line 2	3	
4a	Gross income from property held for investment (excluding any net gain from the disposition of property held for investment). See instructions	4a	
4b	Net gain from the disposition of property held for investment. See instructions	4b	
4c	Net capital gain from the disposition of property held for investment. See instructions	4c	
4d	Subtract line 4c from line 4b. If zero or less, enter -0-	4d	
4e	Enter all or part of the amount on line 4c that you elect to include in investment income. Do not include more than the amount on line 4b. See instructions	4e	
4f	Investment income. Add line 4a, line 4d, and line 4e	4f	
5	Investment expenses. See instructions	5	
6	Net investment income. Subtract line 5 from line 4f	6	
7	Disallowed investment interest expense to be carried forward to 2003. Subtract line 6 from line 3. If zero or less, enter -0-	7	
8	Investment interest expense deduction. Enter the smaller of line 3 or line 6. Form 541 filers, stop here and see instructions. All other filers, go to line 9	8	
9	Enter the amount from federal Form 4952, line 8	9	
10	California investment interest expense deduction adjustment. Enter the difference between line 8 and line 9. See instructions.	10	

What's New

For taxable years beginning on or after January 1, 2002, California law was changed to clarify the method used to calculate loss carryovers, deferred deductions, and deferred income for nonresident and part-year resident taxpayers. This new law changes the tax computation to recognize those items, and establishes a new method to determine percentages for computing tax for all nonresidents and part-year residents. Beginning this year, the nonresident tax forms (Long and Short Form 540NR) have been revised to more clearly show that nonresidents pay tax to California only on their California taxable income. For further information, get FTB Pub. 1100, Taxation of Nonresidents and Individuals Who Change Residency.

General Information

In general, California law conforms to the Internal Revenue Code (IRC) as of January 1, 2001. Therefore, California has conformed to the income tax changes made to the IRC by the federal Internal Revenue Service Restructuring and Reform Act of 1998 (Public Law 105-206), the Tax and Trade Relief Extension Act of 1998 (Public Law 105-277), the Surface Transportation Revenue Act of 1998 (Public Law 105-178), the Ricky Ray Hemophilia Relief Fund Act of 1998 (Public Law 105-369), the Ticket to Work and Work Incentives Improvement Act of 1999 (Public Law 106-170), the Miscellaneous Trade and Technical Corrections Act of 1999 (Public Law 106-36), the FSC Repeal and Extraterritorial Income Exclusion Act of 2000 (Public Law 106-519), the Consolidated Appropriations Act of 2001 (Public Law 106-554), and to technical corrections made by the Economic

Growth and Tax Relief Reconciliation Act of 2001 (Public Law 107-16). However, there are continuing differences between California and Federal law. California has not conformed to some of the law changes made by the Economic Growth and Tax Relief Reconciliation Act of 2001 (Public Law 107-16) or the federal Job Creation and Worker Assistance Act of 2002 (Public Law 107-147).

Specifically, for tax years beginning after December 31, 1992, under federal law, net capital gain from the disposition of property held for investment is excluded from investment income when figuring the investment interest limitation. However, taxpayers may elect to include in their investment income as much of their net capital gain investment income as they choose if they also reduce the amount of net capital gain eligible for the special federal capital gain tax rate. California conforms to this federal provision for tax years beginning on or after January 1, 1997.

This form allows you to make a separate California election to include net capital gain investment income in the calculation of the investment interest limitation. However, California does not have a special capital gain tax rate (all income is taxed at the same rate), and you should consider the effect on your California tax before making a separate California election or applying the federal election for California purposes.

A Purpose

Interest expense paid by an individual, estate, or trust on a loan allocable to property held for investment may not be fully deductible in the current year. Use form FTB 3526 to figure the amount of investment interest expense

deductible for the current year and the amount, if any, to carry forward to future years.

B Who Must File

If you are an individual, estate, or a trust and you claim a deduction for investment interest expense, you must complete and attach form FTB 3526 to your tax return.

Exception: You do not have to file form FTB 3526 if all of the the following apply:

- Your only investment income was from interest or dividends;
- You have no other deductible expenses connected with the production of interest or dividends;
- Your investment interest expense is not more than your investment income; and
- You have no disallowed investment interest expense from 2001.

Specific Instructions

Generally, California law for the investment interest expense deduction follows federal law. Get the instructions for federal Form 4952, Investment Interest Expense Deduction, for more information. Get federal Pub. 550, Investment Income and Expenses, to determine your investment interest expense deduction if you have interest income or expense attributable to a working interest in oil or gas property or if you paid or accrued interest on a loan and you used the proceeds of the loan for more than one purpose.

Line 1 – Investment Interest Expense

Enter the investment interest paid or accrued during the tax year, regardless of when you incurred the indebtedness. Investment interest expense is interest paid or accrued on a loan (or

part of a loan) that is allocable to property held for investment.

Include investment interest expense reported to you on Schedule K-1 (100S, 541, 565, or 568). Include amortization of bond premiums on taxable bonds purchased after October 22, 1986, but before January 1, 1988, unless you elected to offset amortizable bond premiums against the interest payments on the bond. A taxable bond is a bond on which the interest is includible in gross income.

Investment interest expense does not include:

- Qualified residence interest;
- Interest expense that is properly allocable to a passive activity (see "Passive Activities" below);
- Interest expense that is capitalized, such as construction interest subject to IRC Section 263A; or
- Interest expense related to tax-exempt interest income under R&TC Section 17280.

Property Held for Investment. Property held for investment includes property that produces investment income (unless derived in the ordinary course of a trade or business). It also includes property that produces gain or loss, **not** derived in the ordinary course of a trade or business, from the disposition of property that produces these types of income or is held for investment.

However, it does not include an interest in a passive activity (see "Passive Activities" below).

Property held for investment also includes an interest in an activity of conducting a trade or business in which you did not materially participate and that is not a passive activity. For example, a working interest in an oil or gas property that is not a passive activity is property held for investment if you did not materially participate in the activity.

Passive Activities. Generally, a passive activity is any business activity in which you do not materially participate and any rental activity regardless of your level of participation. Investment interest expense does not include any interest expense that is included when determining your income or loss from a passive activity. However, interest expense that is properly allocable to portfolio income is investment interest expense and is not included when determining your income or loss from a passive activity. Portfolio income includes income (not derived in the ordinary course of a trade or business) from interest, dividends, annuities, royalties, and net gain from the disposition of property held for investment. Beginning in 1994, and for federal purposes only, rental real estate activities conducted by persons in a real property business are not automatically treated as passive activities. California does not conform to this provision. For more information about passive activities, get the instructions for federal Schedule E, Supplemental Income and Loss.

Line 4a – Gross Income from Property Held for Investment

Enter your gross income from property held for investment. This includes income (not derived in the ordinary course of a trade or business) from

interest, dividends, annuities, and royalties. Net income from the following passive activities is also treated as investment income:

- Rental of substantially nondepreciable property;
- Equity-financed lending activities; and
- Acquisition of certain interests in a pass-through entity licensing intangible property.

Also include on line 4a (or line 4b, if applicable) net passive income from a passive activity of a publicly traded partnership, as defined in IRC Section 469(k)(2), investment income reported to you on Schedule K-1 (100S, 541, 565, or 568), and net investment income from an estate or trust.

Line 4b

Enter your net gain from the disposition of property held for investment. This is the excess of total gains over total losses from the disposition of property held for investment. When figuring this amount, include capital gain distributions from mutual funds.

Line 4c

Enter your net capital gain from the disposition of property held for investment. This is the excess of your net long-term capital gain over net short-term capital loss from the disposition of property held for investment. Capital gain distributions from mutual funds are treated as long-term capital gains.

Line 4e

Net capital gain from the disposition of property held for investment, line 4c, is excluded from investment income. However, you may elect to include in investment income all or part of the net capital gain from the disposition of property held for investment. You must make the election no later than the due date (including extensions) of your California income tax return. Once made, the election may not be revoked without the consent of the Franchise Tax Board.

To make the election, enter all or part of the amount on line 4c, but not more than the amount on line 4b, that you elect to include in investment income.

Line 5 – Investment Expenses

Investment expenses are your allowed deductions, other than interest expense, directly connected with the production of investment income. For example, depreciation or depletion allowed on assets that produce investment income is an investment expense.

Include investment expenses reported to you on Schedule K-1 (100S, 541, 565, or 568).

Investment expenses do not include any deductions taken into account in determining your income or loss from a passive activity.

If you have investment expenses that are included as a miscellaneous itemized deduction on federal Schedule A (Form 1040), line 22, the 2% adjusted gross income limitation on federal Schedule A (Form 1040), line 25, may reduce the amount you must include on form FTB 3526, line 5.

Include on form FTB 3526, line 5, the **smaller** of:

- The investment expenses included on federal Schedule A (Form 1040), line 22, or
- The total on federal Schedule A (Form 1040), line 26.

If you made adjustments to your miscellaneous expenses on Schedule CA (540 or 540NR), California Adjustments, be sure to include the adjustments in the calculation.

If you have investment expenses reported on a form or schedule other than federal Schedule A (Form 1040), include those expenses when figuring investment expenses for line 5.

Line 8 – Investment Interest Expense Deduction

Form 541 filers should enter the amount on line 8 as a deduction on Form 541, line 10. All other filers must complete line 9.

At-Risk Activities. If any portion of the deductible investment interest expense on line 8 is attributable to an activity for which you are not at risk, you must also complete federal Form 6198, At-Risk Limitations, (using California amounts) to figure your deductible investment interest expense. Get federal Form 6198 and instructions for more information.

After you figure the allowable investment interest expense on form FTB 3526, enter the portion attributable to the at-risk activity on federal Form 6198, line 4. Reduce form FTB 3526, line 8 by the same amount.

Refer to federal Form 6198 and its instructions for more details, especially the instructions for line 4 of that form.

Line 10 – California Investment Interest Expense Deduction Adjustment

The amount on line 10 is the difference between the deduction allowed by California and the deduction allowed under federal law.

If line 8 is more than line 9, subtract line 9 from line 8. Enter the result as a positive amount on line 10 and on Schedule CA (540 or 540NR), line 39. Be sure to write "FTB 3526" on Schedule CA (540 or 540NR), line 39.

If line 9 is more than line 8, subtract line 8 from line 9. Enter the result as a negative amount on line 10 and on Schedule CA (540 or 540NR), line 39. Be sure to write "FTB 3526" on Schedule CA (540 or 540NR), line 39.

Note: If any portion of your investment interest expense on line 8 is attributable to royalties, enter the difference between the California and federal amounts on Schedule CA (540 or 540NR), line 17, column B or column C, as appropriate.

Alternative Minimum Tax (AMT). Deductible investment interest expense may be an AMT adjustment. Get Schedule P (540, 540NR, or 541), Alternative Minimum Tax and Credit Limitations, for more information.